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C O N F I D E N T I A L SECTION 01 OF 03 HONG KONG 000733

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TAGS: [PGOV](#) [ECON](#) [EFIN](#) [HK](#) [CH](#)
SUBJECT: "GOOD TIMES" BUDGET PROPOSED

REF: HONG KONG 687

Classified By: EP Section Chief Simon Schuchat; Reasons: 1.4 (b/d)

SUMMARY/COMMENT

11. (C) A dearth of newsy initiatives in Financial Secretary Henry Tang's February 22 budget speech reflects continued cyclical good times. There appears to be broad agreement here that there are no big new problems requiring short-term changes to economic policy or a significant redirection of government resources. Tang, however, will likely find himself criticized for the speech on two counts. First, his offer of only very limited tax concessions will disappoint the one-third of salaried workers who pay income taxes to begin with and would like to see some relief from mortgage payments that have risen rapidly with local interest rates. Second, Tang's laying out of tangible steps towards a consumption tax will be politically unpopular with just about everyone -- except the very few who have contemplated the HKG's existing volatile revenue structure and consider a consumption tax a necessary step towards addressing it. END
SUMMARY/COMMENT

A TINY TAX CUT

12. (C) Financial Secretary Henry Tang's February 22 budget speech -- a "second reading" to the legislature of the Appropriations Bill for 2006 -- revealed a small revenue surplus for the 2005-06 budget period, the second in a row, thanks to recently strong economic performance -- 8.6 percent GDP growth in 2004 (revised upward today) and 7.3 percent in 2005 (released today). Anticipation of the surplus had fueled hopes from the middle and upper classes for an income tax cut; these taxpayers find themselves increasingly squeezed by higher payments linked to their adjustable-rate mortgages. Tang, however, offered only token cuts, suggesting a shaving of one percent off the marginal rate for the upper three tax brackets. He also proposed extending the deduction period for interest on mortgages from seven to ten years.

13. (SBU) Tang did not comment on lowering or rationalizing the duties on alcoholic beverages. Several diplomatic missions in Hong Kong, including our own, have over the years pressed for a revision of the duties, especially for wine (presently 80 percent).

CONCRETE STEPS TOWARDS A CONSUMPTION TAX

¶4. (C) Tang said the HKG would announce details in mid-2006 of a plan for a consumption tax (Goods and Services Tax, or GST), and that this will be followed by public consultations. He did not specify whether the proposed GST would be revenue neutral. Tang did state an intention to offer GST tax refunds to visitors and to provide relief to lower-income residents. Deputy Finance Secretary Martin Glass told a Consular Corps briefing that the GST would be low, simple, and broad-based. Glass acknowledged that this initiative would be hard to sell to the public, which is already showing signs of a "knee-jerk reaction." He pointed out that only one-third of Hong Kong's work force presently pays income taxes. A GST, by contrast, affects everyone, and is naturally unpopular. While today's move towards a consumption tax was tangible, JP Morgan Greater China Economist Daniel Hui pointed out that the underlying mechanics involved suggest that such a levy will not be implemented before 2010.

¶5. (U) A consumption tax, however, is important in the longer term for Hong Kong as a way to stabilize government revenue flows, in the view of Government Economist K.C. Kwok, who also chaired the Consular Corps briefing. We note that HKG revenue sources are highly volatile according to economic conditions. The tax base remains narrow, with income taxes and various fees accounting for most government revenue, and yields from these sources move up and down with economic performance and property value swings. Further, around 20 percent of fiscal intake over time has come from highly volatile non-tax sources such as land sales and interest rate-sensitive returns on accumulated surpluses. Because of Hong Kong's USD-pegged exchange rate and lack of any capital controls, the HKG must be careful not to slip into projected

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chronic deficits that would draw on the accumulated reserves necessary for maintaining the currency link.

FISCAL GOALS REACHED AHEAD OF TIME -----

¶6. (U) Kwok pointed out that the HKG has as of this year reached several fiscal targets three years earlier than planned. Government expenditure stands below the HKD 200 billion mark (USD 26 billion). The HKG's consolidated as well as operating budgets are both now in balance, for the first time in eight years. Government expenditure amounts to less than 20 percent of GDP.

NEW INITIATIVES -----

¶7. (C) Tang spoke at length about Hong Kong enhancing its value-adding capabilities and developing in a manner that is "win-win" with the mainland's own economic trajectory. He described a city whose economic future depends on bolstering employee skills and expanding physical infrastructure, both of which are necessary to support Hong Kong's role as a regional business platform. Tang touched on numerous elements of "soft infrastructure" such as investor protections, the beneficial free trade agreement with China, and a committee presently looking into the potential utility of a competition law. He noted challenges such as labor market skills mis-match, avian influenza, environmental degradation, and the need to attract overseas talent. All that said, Tang made few proposals of note for new expenditures or even low-cost pilot initiatives, merely offering tweaks in line with existing trends. Some of the more noteworthy proposals, all of which are either small in scale or build on existing initiatives, include:

- o TALENT PROGRAM: A new program to attract mainland and overseas talent; DepSec Glass said in the briefing that the aim is to attract accomplished workers with impressive qualifications, and that a pre-existing job offer would not

be required to obtain the right to stay in Hong Kong and look for work for up to one year.

o INFRASTRUCTURE: A stated commitment to physical infrastructure, with an eye towards creating 14,000 jobs in the weak construction sector. Plans are to earmark HKD 29 billion (USD 3.7 billion) per year. Specific projects still to be determined.

o AID TO DISADVANTAGED: An increase of HKD 100 million per year (USD 13 million) to strengthen rehabilitation services, family support, and child development.

o EMPLOYMENT: HKD 230 million (USD 30 million) over five years to assist the unemployed and help them achieve self-reliance.

o "GREEN" TAXES: Intention to promote the "polluter pays" principle through tax policy, including programs to encourage the recovery of tires, reduce the use of plastic bags, and promote electric vehicles.

WHERE THE MONEY COMES FROM

18. (U) The figures below were provided to the Consular Corps, detailing anticipated 2006-07 revenue of HKD 257.3 billion (USD 33 billion).

UNIT = PERCENTAGES

CATEGORY	2006-07
Profits Tax	27.5
Land Premium	11.9
Salaries Tax	16.1
Rates (Property Related)	6.0
Stamp Duties	5.8
Utilities/Fees/Charges	5.7
Properties/Investments	6.2
Betting Duty	4.6
Land Fund	3.1
Duties	2.6
Other Operating	3.9
Other Capital	6.6

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WHERE THE MONEY GOES

19. (U) The figures below are percentages of budget allocations based on original estimates for 2005-06 and 2006-07, provided to the Consular Corps. The recurrent government expenditure in 2005-06 was HKD 247.8 billion (USD 31.7 billion) and for 2006-07 was HKD 245.6 billion (USD 31.4 billion).

UNIT = PERCENTAGES

CATEGORY	2005	2006
Education	23.6	23.0
Social Welfare	14.5	14.8
Health	13.0	13.2
Security	10.6	11.0
Infrastructure	10.9	9.9
Economic	4.7	4.8
Environment and Food	4.3	4.7
Community/External Affairs	8.3	8.4
Housing	0.1	0.1
Support (Operational)	14.9	15.1

